

**Tax-Exempt Bond Examination Results
Are Used to Focus Customer Education
Programs**

August 2003

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

August 19, 2003

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT
ENTITIES DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Assistant Inspector General for Audit (Small Business and
Corporate Programs)

SUBJECT: Final Audit Report – Tax-Exempt Bond Examination Results Are
Used to Focus Customer Education Programs
(Audit # 200210050)

This report presents the results of our review to determine if Office of Tax Exempt Bonds (TEB) management uses the results of tax-exempt bond examinations to focus their taxpayer education and outreach efforts in order to provide Tax Exempt and Government Entities (TE/GE) Division customers with top quality service by helping them to understand and comply with the applicable tax laws.

In summary, we found that TEB function management adequately used the results of examinations to focus their taxpayer education and outreach programs. Interpretive guidance had been developed for all examination issues involving noncompliance that we reviewed. The TE/GE Division's Internet website provides customers with links to interpretative documents related to tax-exempt bonds, such as Private Letter Rulings and Field Service Advice. However, the website does not have interpretative guidance for all applicable Internal Revenue Code (I.R.C.) sections related to tax-exempt bonds, nor does it have direct links to the applicable I.R.C. sections. Consequently, we recommended that the Director, TEB, modify the TE/GE Division's Internet website to provide direct links to applicable I.R.C. sections.

Management's Response: The Commissioner, TE/GE Division, agreed with our recommendation and will modify the website to include links to applicable I.R.C. sections. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the Internal Revenue Service managers who are affected by the report recommendation. Please contact me at (202) 622-6510 if you

have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

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Tax-Exempt Bond Examination Results Are Used to Focus Customer Education Programs

Background

The Office of Tax Exempt Bonds (TEB) within the Tax Exempt and Government Entities (TE/GE) Division administers the Federal tax laws applicable to tax-exempt bonds. Tax-exempt bonds include governmental and qualified private activity certificates of debt that are issued by state and local governments or by organizations acting on their behalf, such as universities and non-profit organizations. They are used to finance various tax-exempt projects, such as courthouses, hospitals, airport expansions, and highways.

Bond issuers are required to meet certain requirements under the Internal Revenue Code (I.R.C.)¹ for the interest received by the bondholders to be exempt from Federal income tax. If the proceeds of the tax-exempt bonds are not used for their intended purpose, the bond may no longer be tax-exempt, and the issuing organization may be liable for the taxes as well as paying sanctions.² TEB function management stated that bond customers paid \$9.9 million in sanctions in Fiscal Year (FY) 2000, \$5.7 million in FY 2001, and \$31.7 million in FY 2002.

The tax-exempt bond sector is experiencing dramatic growth. Between 1985 and 2000, more than 400,000 Information Returns for Tax-Exempt Bonds (Form 8038)³ were filed with the Internal Revenue Service (IRS). During the same period, the value of outstanding bonds grew by more than 125 percent, from \$650 billion to nearly \$1.5 trillion. In addition to the growth, regulations governing tax-exempt bonds are among the most complex in tax administration.

The goal of the TEB function is to provide its customers with top quality service by helping them understand and comply with the applicable tax laws and protect the public's

¹ I.R.C. Section (§)103(a) (2002) is the primary statutory provision that excludes interest on municipal bonds from Federal income tax.

² Sanctions are payments intended to enforce compliance.

³ Forms 8038 are filed when bonds are issued. Usually, the bond issuer is not required to file any additional forms in relation to the bond issuance unless there is an obligation to pay arbitrage rebate. This number also includes the number of Information Return For Tax-Exempt Governmental Obligations (Form 8038-G) that were filed.

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interest by applying the tax laws with integrity and fairness. To achieve this goal, the TEB function has concentrated its efforts in three areas:

- The Customer Education and Outreach Program is designed to assist members of the bond industry in understanding their tax responsibilities. TEB function management believes that one potential reason for noncompliance is a lack of understanding of the complex legal requirements.
- The Voluntary Compliance Program is designed to foster voluntary resolution of violations of the I.R.C.
- The Examination Program is designed to determine if bond issuers comply with the legal guidelines for tax-exempt bonds. The TEB function completed 344 examinations in FY 2002, which included both correspondence examinations and field examinations.
 - A correspondence examination is a limited scope examination conducted via correspondence. If significant tax issues are identified during a correspondence examination, the examination may be converted to a field examination of the bond issuance.
 - A field examination is a broader scope examination that ensures bond issuers comply with the pre- and post-issuance requirements necessary for the bond issuance to qualify for and maintain tax-exempt status.

The TEB function tracks noncompliance issues identified from examinations to determine where to focus future educational efforts in order to reduce noncompliance. At the time we began our audit, principal issues of potential noncompliance were input to the Quarterly Field Reports⁴ and forwarded to the TEB function headquarters office each quarter. During our audit fieldwork, the TEB function began using the Audit Information Management System

⁴ Quarterly Field Reports are used by the TEB function to track its inventory of examination cases.

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(AIMS)⁵ to manage its inventory of open examination cases and capture information about issues that were identified during examinations. In addition, examiners prepared Exempt Organization Examined Closing Records (Form 5599) to record and capture primary issue codes that indicate specific areas of noncompliance. Periodically, TEB function examiners and management have focus group meetings to identify the prevalent issues that should be addressed through customer education.

This audit was performed at the TEB function headquarters office in Washington, D.C., between September 2002 and June 2003 in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Tax-Exempt Bond Examination Results Are Used to Focus Customer Education Programs, but Additional Information Should be Provided to Improve Customer Service

The TEB function adequately used the results of examinations to focus its taxpayer education and outreach programs. We reviewed the potential examination results for a random sample of 34 of the 62 open TEB function examinations included on the September 2002 Quarterly Field Report and determined that the TEB function had identified 46 noncompliance issues in these examinations. Some of the 46 issues appeared in more than 1 examination. For example:

- Issues relating to I.R.C. § 103(a), Interest on State and Local Bonds – Noncompliance issues were raised in 24 (71 percent) of the 34 examination cases that we reviewed.
- Issues relating to I.R.C. § 103(b), Interest on State and Local Bonds – Noncompliance issues were raised in 17 (50 percent) of the 34 examination cases that we reviewed.
- Issues relating to I.R.C. § 142(a)(6), Exempt Facility Bond – Solid Waste Disposal Facilities – Noncompliance issues were raised in 9 (26 percent) of the 34 examination cases that we reviewed.

⁵ The AIMS provides inventory and activity controls of active examination cases.

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The remaining 43 issues did not recur as frequently. At the time of our review, the TEB function tracked principal issues of potential noncompliance on the Quarterly Field Reports. TEB function management informed us these issues will be tracked on the AIMS through the use of issue codes in the future.

We determined that, as part of the TEB function Education and Outreach Program, interpretive guidance for all 46 issues had been developed, posted to the TE/GE Division's Internet website, and/or addressed in other documents to assist members of the bond industry in understanding their tax responsibilities. This guidance was presented in the form of Private Letter Rulings (PLR), Field Service Advice (FSA), and IRS publications.⁶ However, the website does not have interpretive guidance for all applicable I.R.C. sections related to tax-exempt bonds. The TEB function monitors the effect of its Education and Outreach Program by examining similar bond issuances in subsequent fiscal year examination programs to determine if the noncompliance occurrence rate decreases.

The TE/GE Division's Internet website contains useful information that is beneficial for TEB function customers. To determine the sources of information on the website that members of the bond community frequently use and obtain these customers' assessments of these sources, we interviewed members of the National Association of Bond Lawyers (NABL) and the Government Finance Officers Association (GFOA).

Representatives from both groups were complimentary of the services provided by the TEB function. Both groups use the TE/GE Division's Internet website to research IRS procedures and interpretive guidance, such as Internal Revenue Bulletins, Cumulative Bulletins, Technical Advice Memoranda, PLRs, FSAs, the Internal Revenue Manual, and Continuing Professional Education information. The

⁶ TEB function management had prepared three IRS publications. One publication (Tax-Exempt Governmental Bonds (Publication 4079)) was posted to the TE/GE Division's Internet website prior to this report being ready for release; the other two publications had not been released by the close of audit fieldwork.

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NABL and GFOA representatives indicated that they rely on the website for guidance and have direct links from their respective websites to that of the TE/GE Division.

The TE/GE Division provides other avenues of education for customers in addition to the website. Both groups mentioned that meetings and direct telephone access with TE/GE Division staff have been helpful. For example:

- The Director, TEB, participated in the 2002 Bond Attorneys Workshop, where over 900 bond and tax attorneys were in attendance. The Director spoke at the workshop, and the speech was later published in the NABL quarterly magazine.
- TE/GE Division employees participated in and distributed TEB function literature at the GFOA annual conference and special committee meeting. Approximately 5,000 GFOA members attended the annual conference.

The NABL and GFOA representatives offered suggestions on how the TEB function could improve its taxpayer education efforts. The suggestions included sending its members e-mail alerts when new educational information was added to the TE/GE Division's Internet website and providing bond customers with more published guidance. We shared the specific suggestions with TEB function management.

We identified another opportunity for improving service to TEB function customers by reviewing the IRS' Large and Mid-Sized Business (LMSB) Division's efforts to provide guidance to its customers. We chose the LMSB Division because its customers are similar to those of the TEB function in that its customers are the largest business taxpayers who also deal with complex tax law issues. In addition, both the TEB and the LMSB Division Examination functions perform relatively few, but very large, examinations. The LMSB Division's Internet website contains direct links to the I.R.C. sections applicable to its customers.

In contrast, the TE/GE Division's Internet website does not have direct links to the applicable I.R.C. sections relating to

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tax-exempt bonds. Direct links to the I.R.C. would be very beneficial to customers, especially since the TEB function does not have interpretative guidance for all applicable code sections. TEB function management had not considered this option because they did not know that it was technically feasible.

This improvement would help the TEB function provide better service to its customers and potentially increase compliance with the I.R.C. The direct links would ensure that customers have access to information related to all tax-exempt bond issues.

Recommendation

1. The Director, TEB, should modify the TE/GE Division's Internet website to provide direct links to the I.R.C. sections applicable to tax-exempt bonds.

Management's Response: GE function management has informed the Electronic Tax Administration (ETA) of the need to create links to I.R.C. sections on their website. The ETA has committed to establish these links after Chief Counsel converts the information data to the Extensible Markup Language format, which is scheduled for November 2003.

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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine if Office of Tax Exempt Bonds (TEB) management uses the results of tax-exempt bond examinations to focus their taxpayer education and outreach efforts in order to provide Tax Exempt and Government Entities (TE/GE) Division customers with top quality service by helping them understand and comply with the applicable tax laws. To accomplish our objective, we:

- I. Determined if TEB function management had developed effective methodologies for focusing its education and outreach efforts using the results of tax-exempt bond examinations.
 - A. Interviewed TEB function management to identify their process for using the results of tax-exempt bond examinations to focus their taxpayer education and outreach efforts.
 1. Determined how TE/GE Division management identified emerging tax issues that needed to be addressed by their education and outreach efforts.
 2. Identified the steps taken by TEB function management to address emerging issues after they were identified.
 3. Determined how TEB function management tracked emerging issues to ensure they had been addressed by their education and outreach efforts.
 - B. Interviewed Internal Revenue Service (IRS) Large and Mid-Size Business (LMSB) Division management to identify their process for using the results of examinations to focus their taxpayer education and outreach efforts.
 - C. Compared the TEB function's process for focusing its education and outreach efforts using the results of tax-exempt bond examinations with the LMSB Division's examination process to determine if TEB function management could improve their process for leveraging the examination programs.
 - D. Interviewed members of the National Association of Bond Lawyers and the Government Finance Officers Association.
 1. Identified which IRS research sources were used to identify emerging issues regarding tax-exempt bonds.
 2. Obtained an assessment of whether the TE/GE Division's education and outreach efforts were providing customers with the information they needed in the best format, with sufficient details, and in the right timing.

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- II. Determined if the TEB function taxpayer education and outreach efforts were reflective of the noncompliant tax issues identified during tax-exempt bond examinations.
 - A. Identified the most significant noncompliant issues identified during tax-exempt bond examinations.
 - 1. Obtained copies of recent TEB function Quarterly Field Reports.¹
 - 2. Selected a random sample of 34 of the 62 open examination cases with potential noncompliant tax issues from the September 2002 TEB function Quarterly Field Reports.
 - 3. Reviewed the TEB function examination cases to determine the most prevalent noncompliant tax issues identified by TEB function examiners.
 - B. Identified the tax issues addressed by TE/GE Division education and outreach efforts by reviewing the website, pamphlets, publications, minutes from tax forums, and any recent TEB function procedural changes.
 - C. Compared the results of step II. A. with the results of step II. B. to determine if the education and outreach efforts addressed the significant issues raised during TEB function examinations.
- III. Determined the amount of sanctions paid by bond customers during Fiscal Years 2000, 2001, and 2002 through review of TEB function management information reports.

¹ Quarterly Field Reports are used by the TEB function to track its inventory of examination cases.

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Appendix II

Major Contributors to This Report

Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)

Nancy A. Nakamura, Director

Gerald T. Hawkins, Audit Manager

Thomas F. Seidell, Acting Audit Manager

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Yolanda D. Brown, Auditor

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Appendix III

Report Distribution List

Commissioner N:C
Deputy Commissioner for Services and Enforcement N:SE
Director, Government Entities, Tax Exempt and Government Entities Division T:GE
Director, Tax Exempt Bonds, Tax Exempt and Government Entities Division T:GE:TEB
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:AR:M
Audit Liaison:
 Director, Communications and Liaison, Tax Exempt and Government Entities
 Division T:CL

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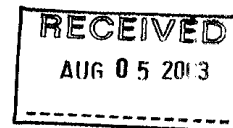
Appendix IV

Management's Response to the Draft Report




DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

JUL 31 2003



MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDIT

FROM: Evelyn A. Petschek, Commissioner
Tax Exempt and Government Entities 

SUBJECT: Draft Audit Report -- Tax-Exempt Bond Examination
Results Are Used to Focus Customer Education
Programs (Audit #200210050)

Thank you for the opportunity to respond to your draft report dated July 18, 2003, regarding the Tax-Exempt Bond Program. The IRS appreciates the efforts and recommendation of your staff. We agree that the addition of direct links on our Internet website to the applicable sections of the Internal Revenue Code would benefit our customers.

Attached is our response to the recommendation in the draft report.

Questions regarding this response should be directed to Charles W. Peterson, Director, Government Entities, T:GE at (202) 283-9738.

Attachment

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Attachment

Identity of Recommendation/Finding #1

The Director, TEB, should modify the TE/GE Division's Internet website to provide direct links to the sections of the I.R.C. applicable to tax-exempt bonds.

Assessment of Cause

The TE/GE Division's Internet website does not have direct links to the applicable sections of the I.R.C. relating to tax-exempt bonds. Direct links to the I.R.C. would be beneficial since Tax-Exempt Bonds does not have interpretative guidance for all code sections. TEB management had not considered this option because they did not know that it was technically feasible.

Corrective Action

GE has informed Electronic Tax Administration (ETA) of the need to create links to I.R.C. sections on the TEB website. ETA has committed to establish these links and has indicated that such capability will be available after Chief Counsel converts information data to XML format. The projected conversion date to XML format is November 2003.

Implementation Date

Completed

Responsible Official

Director, Internet Services Electronic Tax Administration

Corrective Action Monitoring Plan

The conversion of information to XML format will be followed through direct contact with ETA. Internet links will be established once conversion to XML is complete.